Issue 221
31 October 2002
In its 19th year

Fullermoney

Global Strategy and Investment Trends by David Fuller **www.fullermoney.com**

Sentiment has improved for global stock markets following Wall Street's upward dynamics from the July lows, the perception that war against Saddam Hussein has at least been postponed, and bullish seasonal factors, but this is only a rally in a secular bear market.

For global stock market indices, the best hope is that recent lows hold, enabling them to range sideways to somewhat higher, with most remaining beneath their top formations.

Shares have rebounded and some analysts predict a long-term recovery. There is no doubt that the technical picture has improved, for the short term and probably longer. This has emboldened a number of forecasters who talk about the best value for many years. What are their main points? Speculative excesses from the late-1990s bubble have been reversed. Valuations in Europe, Japan and many newly industrialised country markets are attractive, while at least reasonable on Wall Street. They say everyone is bearish and shares have seldom been cheaper in relation to government bonds. Market historians cite the last century's evidence that share indices do not fall for 4 consecutive years. Some economists say interest rates are low and therefore stimulative. Moreover, corporations have slashed costs to become more efficient, and productivity is rising. Many analysts expect a global economic recovery and consequently have bullish forecasts for corporate earnings in 2003/04 and beyond.

"I could make a case for saying the stock market is cheap, but I don't really believe it", said Warren Buffett recently. Personally, I know better than to ignore technical improvement and have written extensively about the upward dynamics in July, and more recently from 10th October onwards. This said, resistance is currently being encountered from medium to longer-term downtrends for indices, and also the August highs where these have been approached. Nevertheless, I expect the October lows to hold during a consolidation. Behaviourally, sentiment has certainly benefited from a perception that war against Saddam Hussein is no longer imminent. Were this perception to change, I suspect demand for shares would contract sharply, at least until a US-led strike commenced. Looking beyond Iraq, I maintain comparisons with the early-1990s are very misleading. Back then, stock markets were in the second half of a super-cycle bull market, global growth was stronger, companies still had pricing power because deflationary pressures had yet to emerge, consumer and especially corporate balance sheets had not been leveraged and capital expenditure was rising, on the way to becoming a boom. The historically favourable equity to government bond yield comparison is of little relevance in today's deflationary environment - look at Japan. Deflation makes stocks more risky, not less.

One of my mantras for the current environment is that "bad things happen following burst bubbles". Most of the "surprises" are unpleasant. The world's three largest economies are either in recession or experiencing minimal growth. Not in my lifetime have corporate balance sheets been leveraged to the extent that we see today. Consequently companies face a borrowing problem, as we see from the corporate bond market, despite low nominal interest rates. In a deflationary environment, this problem is especially serious. Companies have very little pricing power due to the miracle of the microprocessor and also globalisation, which have led to a huge surplus of goods relative to what the world can consume. Consequently real profits, once we look beyond the dodgy accounting, are difficult to achieve. Among the nasty "surprises" we are seeing massive write-downs on corporate investments gone sour. Companies can become more profitable by slashing costs, mainly through layoffs, but most need a strengthening economy to actually grow. Rising unemployment hurts service industries as well as manufacturing.

Consumer confidence has slumped in the US and remains low in Japan and most of Euroland. While I would not make too much of one month's data, US Consumer Confidence figures for October, released on 29th October, were shocking. According to Bloomberg, the September number was 93.3 and the average forecast among economists for October was 90. Yet Consumer Confidence actually plunged to 79.4 - the lowest level for nine years. OK, October was exceptional because terrorist attacks, including the Bali bombing, serial assassinations near Washington DC and the Moscow theatre siege, however far removed geographically, understandably receive huge media coverage. Such events are hardly conducive to retail therapy. Even allowing for October's preoccupation with terrorism, the trend for consumer confidence was already declining in the US and just about everywhere else. Meanwhile, where consumer spending has long been strongest - the US and UK - household debt levels have soared. During uncertain and difficult times, consumers understandably become cautious and rebuild savings where possible. And so they should but this will do no favours for all those countries, from Asia to Europe, which remain overly dependent on the US consumer.

Where does this leave stock markets? Investor sentiment is frequently volatile and it has been improving since 10th October. Seasonal factors are favourable. While I am less impressed by the argument that "stock markets don't decline over 4 consecutive years" - look back beyond the 20th century and declines of up to 5 years are not exceptional - I would not be surprised if most indices recorded gains in 2003. The 3rd year of a US presidential cycle is the most bullish, on average, as the incumbent party uses all its influence to boost growth. The US will have no trouble coordinating its fiscal and monetary policies in an effort to avoid recession, unlike Japan in recent years. Consequently, equity investors have a short to medium-term upside opportunity. However not all opportunities are equal and I will not be backing this one in a big way. The best that I can envisage for stock markets is a lengthy period of sideways to somewhat higher ranging, with most remaining beneath top formations. Another of history's lessons is that in mature markets, most gains are achieved by dividend payments, not capital gains. Dividend yields are nowhere near the levels evident at the bottom of prior bear markets and the economic environment will not enable many companies to increase payouts significantly. I maintain that the post bubble reversion from one extreme to the other, in terms of valuations, usually takes many years.

Interest Rates and Bonds

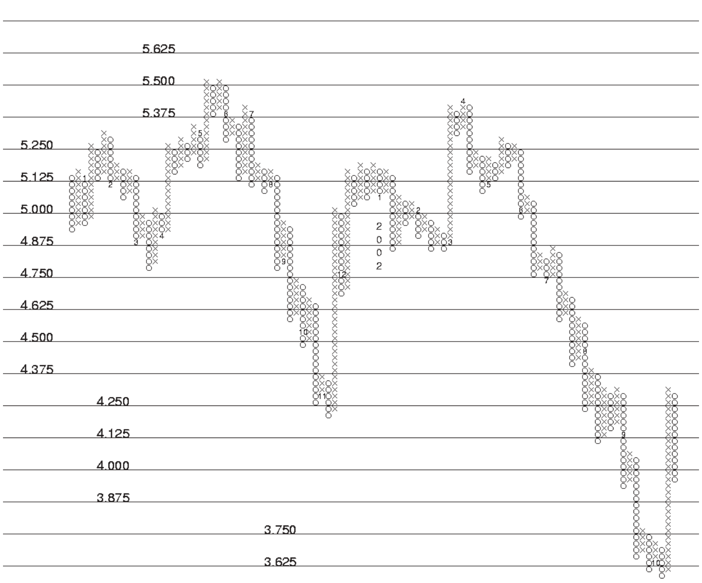
- **The global economy would benefit from lower interest rates but the stock market rally has removed some short-term pressure from central banks.**
- **Western long-dated bond yields have established medium-term lows.**

Only if the stock market rally proves to be a very accurate lead indicator, will it negate the case for lower short-term rates. Equity trends can be a lead indicator, but as they are driven by sentiment, they can also be wildly wrong. In any event, the current rally can only mitigate some of the very bearish sentiment expressed previously. This removes some of the pressure to cut rates from central banks. The issue is further complicated by expectations regarding a possible war against Saddam Hussein. The US Federal Reserve and other central banks will want to retain some monetary ammunition in case the prelude to a war and/or terrorist events add to the forces of recession and deflation.

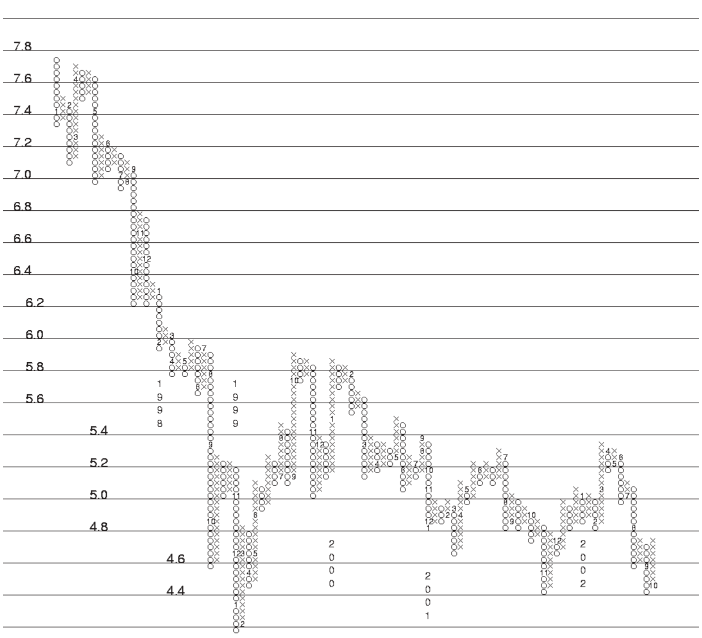
The signal from long-dated bonds could not have been clearer. Look at the P&F chart for US 10-year bond yields. September's decline was the biggest shown, indicating trend acceleration - always an ending characteristic, at least for the short term. The subsequent rebound was explosive, easily breaking the downtrend which commenced in April. This rally has now been checked by resistance from the October 1998 and November 2001 lows - *partially shown, see www.chartanalysts.com (requires subscription) for the full picture.* A consolidation of gains is now underway. If support is encountered above the September-October lows, as I expect, we can look for a further test of overhead resistance. The US long-dated yield chart's pattern is confirmed, albeit less dramatically so, by the other charts shown.

Strategy for bonds - I've liked bonds relative to equities for some time, but I've seen enough recently to change my mind on both a relative and absolute basis. Last month I mentioned that UK and European long-dated bonds would be less vulnerable than their US equivalent in the event of a stock market rally. Subsequently, they have seen less technical damage but I no longer like the charts. Fortunately, European yields are drifting lower at the moment. I would use this opportunity to lighten positions significantly, moving funds into cash or cash equivalents. I would protect any remaining positions with stops near this October's yield highs (price lows). My favourite bond position has been AAA corporate issues, which have had a

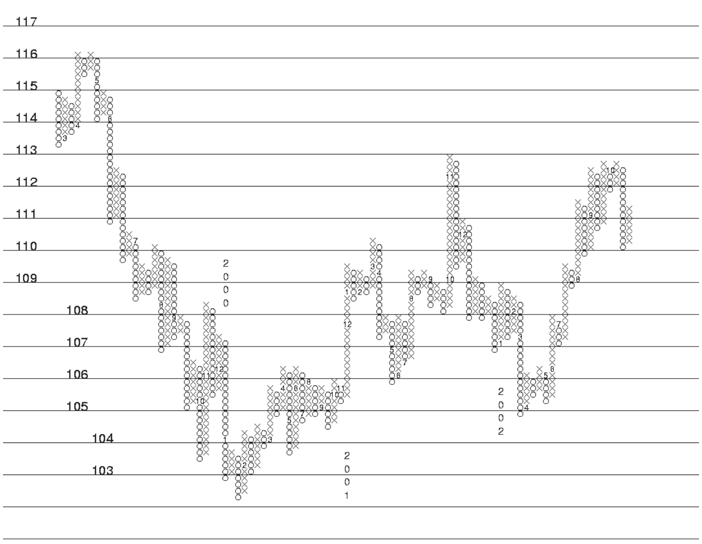
US 10 Year Bond Yield (0.025)



UK 10 Year Bond Yield (0.04)



Euro Bund Futures EUREX (0.2)



great run. However total return charts have now broken their uptrends - not shown but I'll illustrate these in a FMP soon. Consequently, my preference is to move out of these bonds, in favour of cash. The US-listed closed-end (investment trust) Munienhanced Fund Inc (Bloomberg code MEN US) has been a disappointment recently. I would close out this position on the current rally. In futures, my trailing stops on longs were hit, so I'm out of the market, pending developments.

Global Stock Markets

■ **Sentiment has improved in these challenging markets because the July lows held on Wall Street, the prospect of war in the Middle East appears less imminent and earnings have increased in some instances.**

■ **CEO greed is still the norm, especially on Wall Street.**

It has been a challenging environment for all. If you have found stock markets difficult during the last few years, you're in good company, although that's little consolation. There have certainly been trading opportunities (there always are) both long and mainly short. However even the most nimble investors have found it difficult to perform, due to short-term volatility and lack of experience. Very few people had any firsthand knowledge of deflationary pressures and Japan's current example seemed culturally and economically far removed, or so people hoped. Few of today's investment managers, analysts and investors were active in stock markets during the early 1970s. Those who knew their history were reluctant to see any parallels with more recent events, because the '73/'74 market slump was characterised primarily as an inflation problem. Yes, but it was also the aftermath of a super-cycle bull market from 1948 to 1966. Thereafter, it took 8 years before equity valuations completed their cycle of reversion from one extreme of the historic mean to the other, and there had been comparatively little bubble in the late 1960s. Yes, I can recall some excesses but it was an innocent period relative to the late 1990s. Banks got into lending trouble, as they always do, but there was nothing like the misleading accounting, or hyping of shares by investment banking analysts, let alone the leveraging of corporate balance sheets for serial acquisitions and buybacks, to boost share prices and therefore option valuations.

Clear technical improvement is evident and we are approaching a historically bullish phase in the US presidential election cycle. European markets in particular have always taken their cue from Wall Street, and so we have seen recently. The S&P 500 and DJIA encountered support just beneath their July lows and registered key day reversals on 10th October - smaller variations of the upside dynamics seen last summer. These downside failures were followed by sharp rallies, no doubt boosted by short covering. The NASDAQ Index had been weaker in moving somewhat further beneath its July low but has rallied even more strongly than the S&P and DJIA. These rebounds have broken short-term downtrends and in some instances, medium-term downtrends as well. A rule of thumb from The Chart Seminar is that failed breakouts from trading ranges, accompanied by reversal dynamics such as the key day reversal, are often followed by moves that at least test the pattern's opposite boundary - the August highs in this case. Currently, US indices have paused beneath those levels in what appears to be a consolidation of gains before further recoveries are seen. Sustained breaks above the August highs would boost sentiment and provide further technical evidence that important, medium-term lows had been established. Consequently, it continues to look as if we have seen the year's lows, and perhaps beyond, given the generally bullish record during the second half of a US presidential cycle. However, if expectations of an imminent war in Iraq increased, perceptions of an improving environment for equities could easily be reversed, at least until hostilities commenced. Meanwhile, European indices have followed the US lead once again, albeit at a generally slower rate to date.

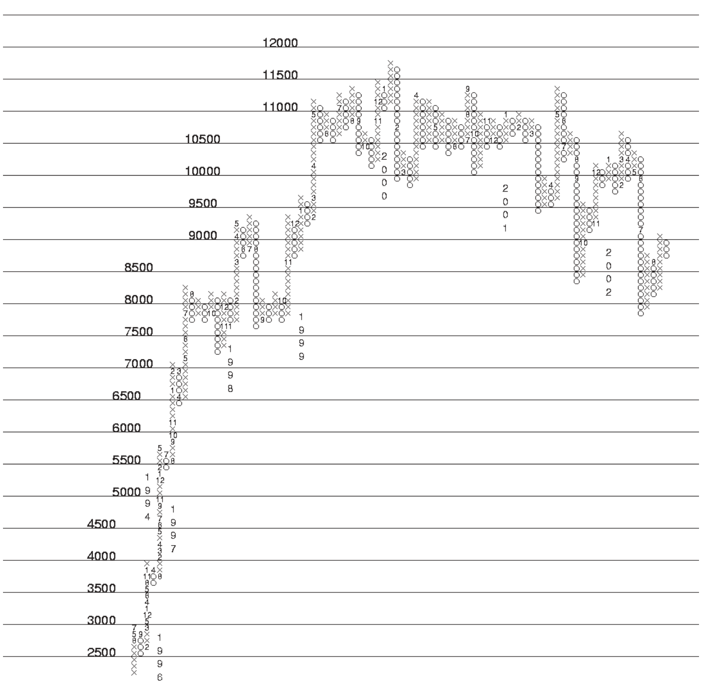
Historically, the third year of a US presidential cycle has provided the best gains, on average. This is no mere coincidence. In the third year, the incumbent president concentrates on the economy, knowing that if it is relatively robust by Election Day, his party has a much better chance of retaining the White House. This focus on the economy, which requires the Federal Reserve's cooperation, understandably persists into the fourth year of the presidential election cycle, making it the second most bullish year, on average. In contrast, any tough measures required, are by presidential choice, generally in the first two years of a term. Will the US stock market in 2003 outperform 2002 and 2001? Probably, since 2001 was a significant down year and it's virtually certain 2002 will be as well. Will 2003 be an up year? This looks like at least an even bet, for cyclical reasons and because the odds have to be against a 4th consecutive year of declines. In a super-cycle bull market, we would have every reason for expecting gains during the third year of the presidential cycle. However, we are in the lengthy post bubble reversion from way above the historic mean for valuations, to an eventual low way below the mean, as has always occurred. There is no credible argument as to why this reversion should not occur over the next decade, unless we think the risk premium for stocks is due for permanent decline, à la that ridiculous best seller from 2000, "Dow Jones 36,000". Bad things happen in post bubble environments, as I've said before. Therefore, stock markets will face many obstacles in 2003.

Bullish investors are betting that there will be no war against Saddam Hussein this year, or perhaps at all. Realisation that President Bush would like to work with the United Nations, provided the Security Council can agree on some effective resolutions, has convinced investors that the threat of imminent war has passed, in favour of renewed arms inspections. This perception is probably correct, despite a cynical holdout by France and Russia, which are more concerned about their contracts with Saddam than his weapons. Nevertheless some sort of Security Council agreement is probable and Saddam will let the inspectors in, as a matter of survival. Presumably Iraq will cooperate, until the inspectors get close to bio-chemical or nuclear weapons facilities important to the Iraqi dictator. If this analysis is incorrect for any reason and war appears imminent once again, it will dominate all other factors in the markets and weigh on sentiment. However, historic evidence suggests that stocks would rally once regime change by military means commenced, in line with the adage, "Sell the rumour, buy the news".

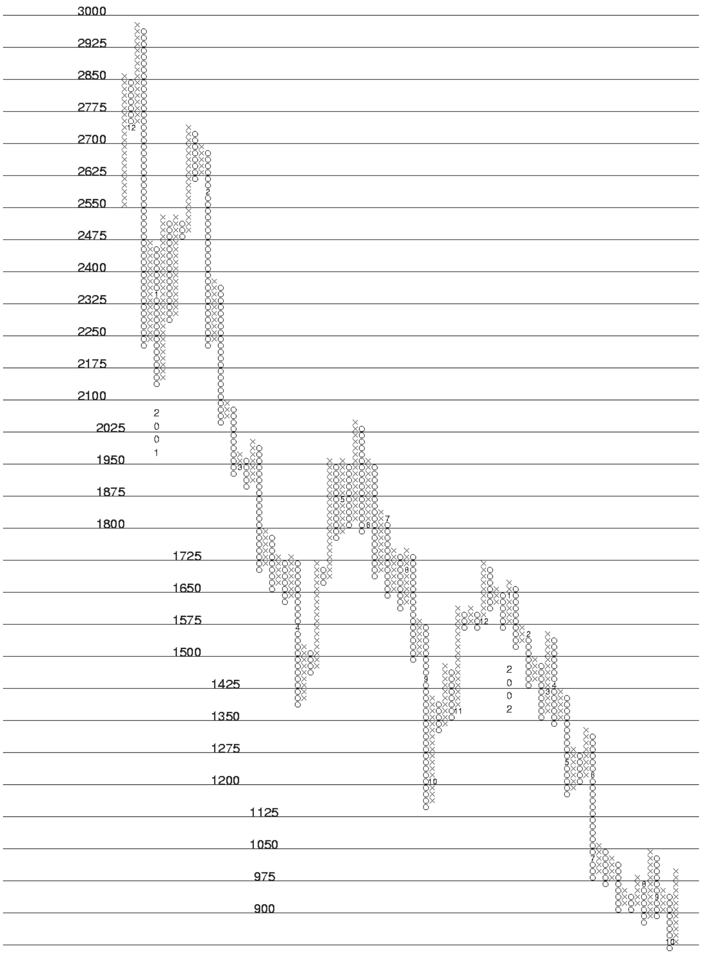
Earnings, at least as reported by companies, are not quite so bad as recently feared. The two main factors behind any genuine improvement in earnings are due to fewer write-offs, in some instances, than occurred in 3Q and 4Q 2001, and especially cost cutting, mainly through staff layoffs. Business conditions have shown little improvement anywhere and have clearly deteriorated in Europe, UK included, and especially Asia. In the US, consumer spending is receding despite an explosion in credit, and corporate capital expenditure remains weak. What growth there is, is mainly coming from military expenditure. Unfortunately, US earnings are too often merely "earnings". In other words, companies continue to overstate their profits, quite legally, by using the ridiculous GAAP (generally accepted accounting principles). Consider IBM, which reported an annual profit of $5.657 billion over the last year. However the rating agency, Standard & Poors, recently said IBM only earned $287.3 million. In other words, IBM overstated earnings by 1869.4 percent. How could it do this? Most of the alleged gain came from an optimistic estimate for the company's pension fund performance. Even if the estimate was realistic, which it isn't, IBM cannot touch the pension fund. In other words, they can't pay a single bill or cent of dividends with it, because it's not company money. Nevertheless estimates for pension fund returns, which are always optimistic, can be listed as a profit in line with GAAP. Go figure.

CEO greed is still the norm, especially in the US. Both CEOs and investors got lucky in the late 1990s. Everybody was winning because the stock market bubble had temporarily become a free lunch. Foolish and/or mischievous promoters said it was a one-off upward adjustment in valuations, because risk was so much lower. The CEO's knew better, because many of them were ripping off the system - ethically, if not according to the letter of the law at that time. They persuaded companies and shareholders to give them vast, incentivised compensation packages, allegedly cheap at the price because their particular knack for genius would make everyone else rich as well. The media fawned over CEOs, elevating them to the status of icons. Meanwhile, corporate management was bribing politicians with campaign contributions, so that they would lean on financial regulators who wanted to blow the whistle on excesses. Many CEOs became serial acquirers, leveraging up companies' balance sheets to unprecedented levels, while hiding debt in the small print of annual reports. Borrowed money was also used for stock buybacks, enabling them to cash in options. At the bottom line, this was the biggest transfer of wealth from shareholders to management in history. There is no modern precedent for

Dow Jones Industrial Average (100pt)



Nasdaq 100 Index (15pt)

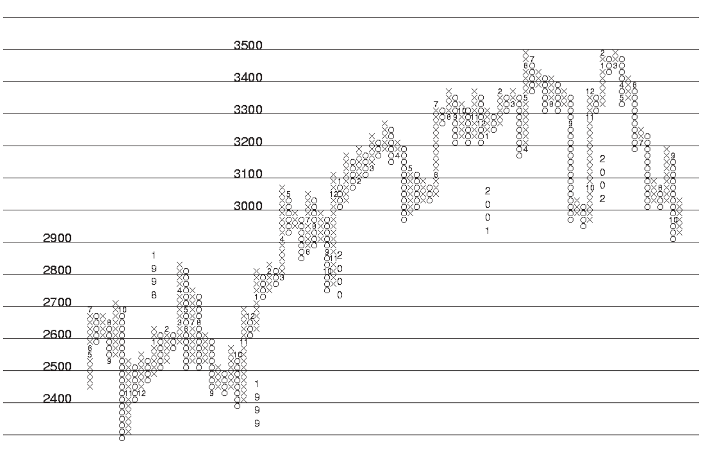


this level of narcissistic greed, not to mention the extent to which it has compromised the efficient, free-market economic model. Do we really believe that this problem has been sorted out by a three-year stock market decline? Forensic accountants are still uncovering dubious policies, to put it kindly. Meanwhile, many companies are lobbying to block or at least water down necessary reforms. Numerous "hidden costs", such as deferred compensation, are still in the system. Capitalism will sort out this crisis and eventually emerge stronger. However it won't be resolved just because the S&P has fallen 50 percent, valuations return to early-1990s levels and a few worst-case CEOs are put in jail. Even a lengthy stock market rally, which is now an even money bet, won't signal that problems emanating from the late-1990's bubble are behind us. I suspect it will take at least a decade to sort out this mess. The corrective process will keep stock markets in trading ranges for many years. Investors will demand higher ethical standards, honest and open accounting, and much higher dividends. The latter will be achieved partly by lower levels for most stock markets over the next few years, and partly by GDP growth, which will almost certainly be slower than in the last decade.

"Greed Logic", is the title of Jeff Fisher's latest article. Veteran subscribers will recall Jeff Fisher's name as I have often quoted him over the years. He wrote "Greed Logic" at my request and you can find it on my website - www.fullermoney.com - under Comment of the Day for Monday, 28th October. I recommend it.

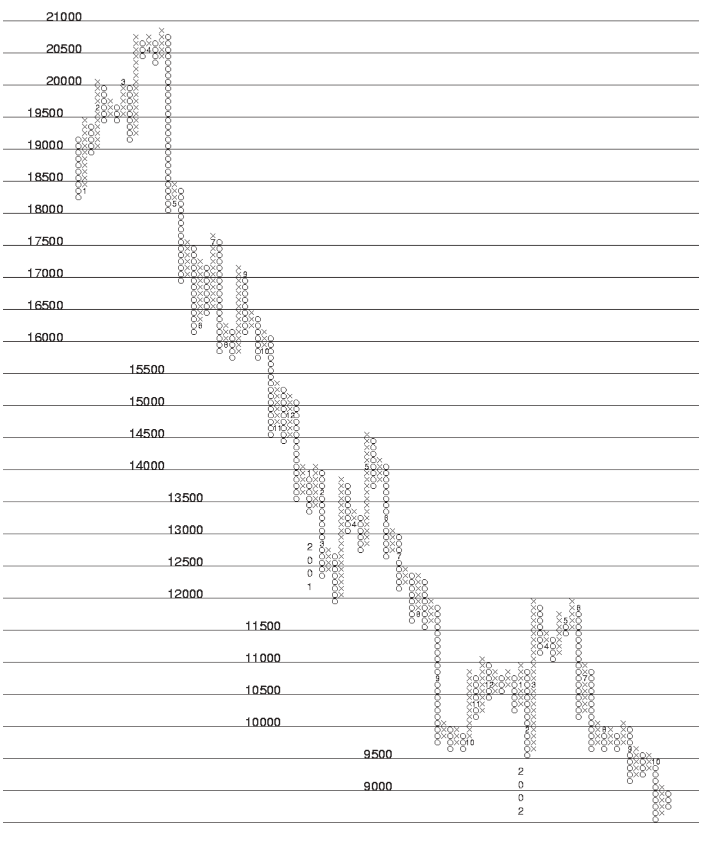
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com. Price levels mentioned refer to market closes.*

Australia S&P ASX 200 (20pt)



The US's Dow Jones Industrial Average (8292) has pushed back above the July 2002 and September 2001 lows in its best rally since April 2001. This provides additional evidence of a medium-term floor, established on 10th October. However the absence of a base and extensive overhead supply will limit upside scope to the best technical rally since last year's low. Similarly, **the NASDAQ 100 (951)** has seen its best rally since November 2001. A move to 1050 would provide additional evidence of a medium-term base. **The Philadelphia Gold & Silver Index (65.05)** - *not illustrated* - has encountered support above its July low

Nikkei 225 Stock Average Index (100pt)



and should rally further. However it needs to push over the September high at 76, to reaffirm the late-stage base hypothesis.

Japan's Nikkei Stock Average (8708) has lagged in the global rally to date. While 8400 would reaffirm the medium-term downtrend, this would be clearly broken by a rally to 9500, confirming a medium-term low.

Australia's S&P ASX 200 Index (3011) - *see previous page* - has not maintained its move beneath the three lows established in April 2000, September 2001 and July-August 2002. Consequently some further test of overhead supply is likely and 2880 is required to reaffirm downward scope.

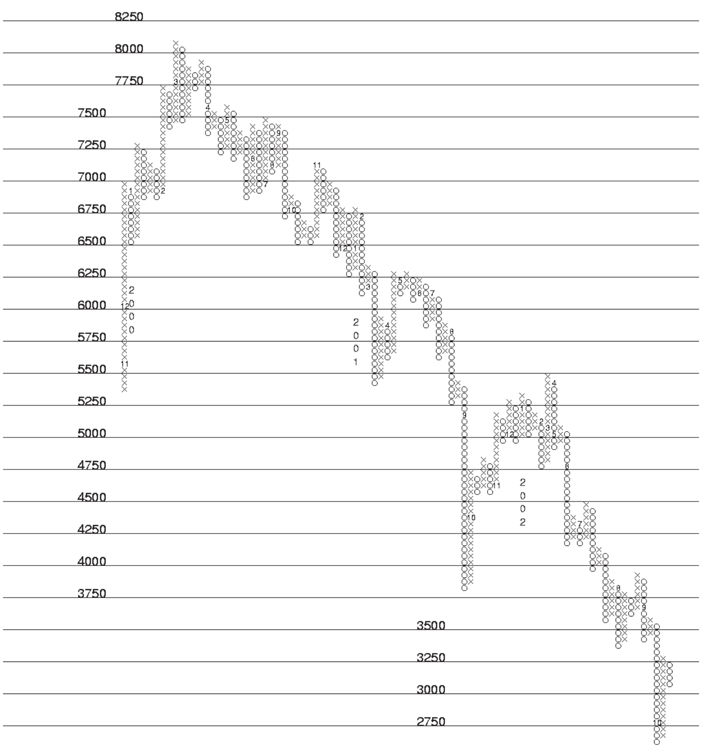
Taiwan's Weighted Price Index (4554) - *not illustrated* - encountered support above its early-October 2001 low and has bounced strongly. Downside risk appears limited to a brief consolidation before an additional rally occurs.

Germany's DAX Index (3022) has been the worst performing major market this year but has just seen its best bounce since last autumn. Provided it can hold most of this October's gains during a consolidation, a further rally should not be long delayed. Interestingly, Germany was Europe's best performing market following the September 2001 low.

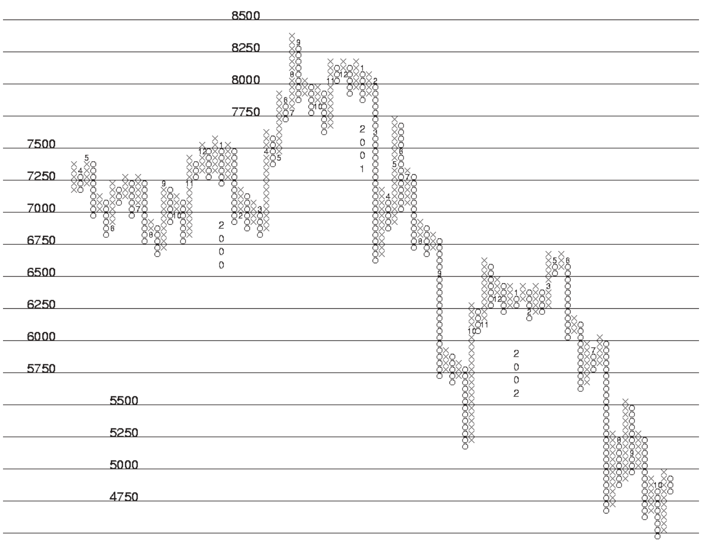
Switzerland's SMI Index (4753) has seen a failed break beneath its July and September lows. A decline to 4760 is now required to question current scope for an additional rally.

The UK's FTSE 100 Index (3935) similarly failed to maintain

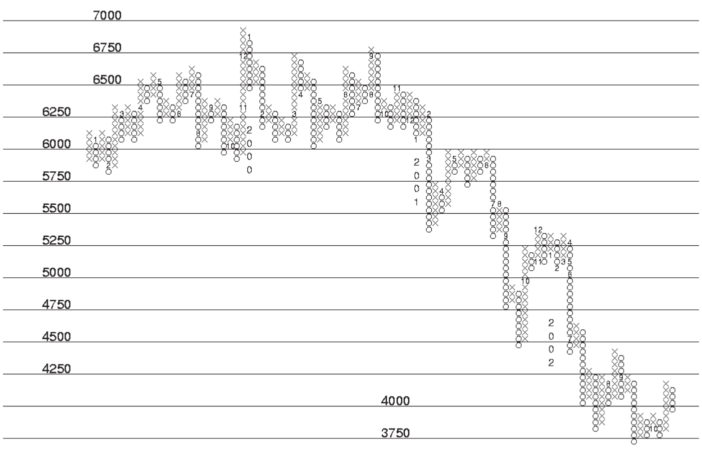
German DAX Index (50pt)



Swiss Market Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



its break beneath the July low. Consequently near-term downside risk appears limited to a brief consolidation before a further rally towards the August high is seen.

Strategy for stock markets - Both the technical picture and sentiment have improved, providing upside trading opportunities and relief for captive investors. There is at least an even chance that this rally lasts longer than people have seen for some time. However, stock market investments at this stage of the post bubble reversion are a roll of the dice. If you are not a gambler, I'd think twice about investing. If you are already in the market, as most of us are to some degree, you will probably have a better selling opportunity over the next year or so. If you have to be in the market, I would concentrate mainly on companies with high, covered yields, low debt and preferably some cash. Among techs, I would stay with proven leaders, such as Nokia and Microsoft. Personally, I'm mostly in cash, some bonds although less than before and yen shorts. My main equity holding is in gold shares and it remains a yoyo ride, although they have improved recently. I'm looking for a long-term recovery in gold but it is best to trade the shares, lightening positions when the better rallies lose momentum and repurchasing when sell-offs do the same. As a UK resident I have several ISAs for tax purposes, mostly invested in the high-yielding stocks that I first mentioned just over a year ago, and the Merrill Lynch World Mining Trust. In futures, I've resisted the temptation to participate because the volatility necessitates closer attention than I wish to devote.

Currencies

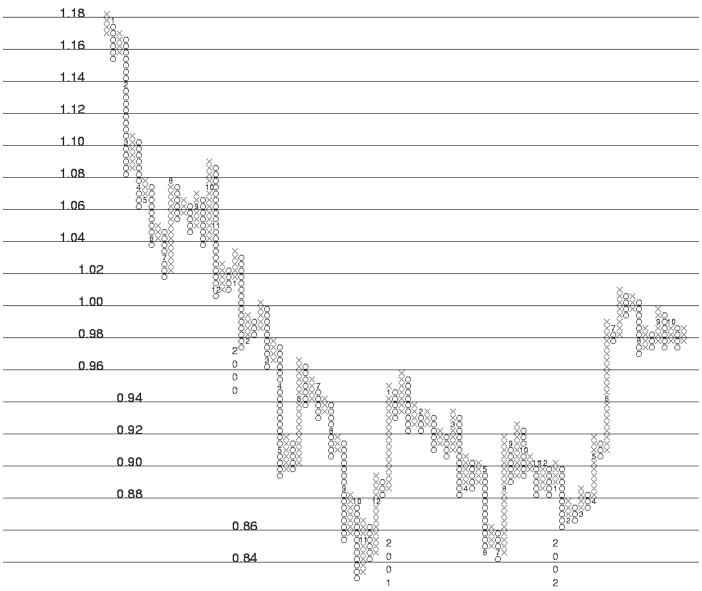
■ **Advances against the yen have paused as Hayami refuses to adopt an inflation target despite three years and counting of unremitting deflation in Japan.**

■ **The euro/dollar rate is searching for a script.**

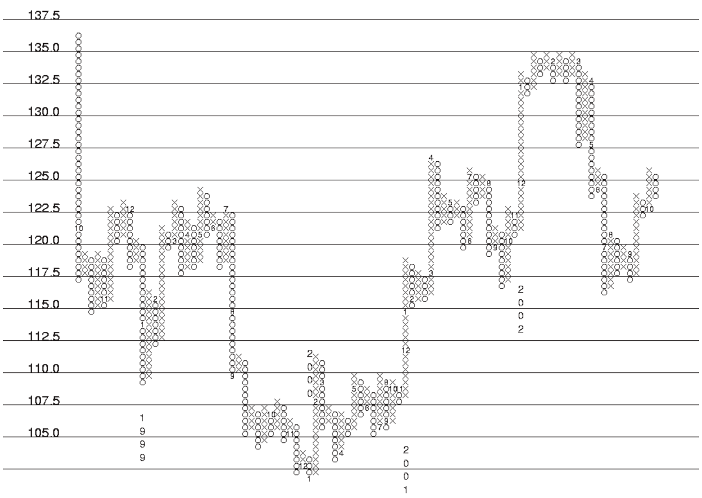
Hayami can still slow the yen's devaluation but he can't prevent it. Deflation is foremost the consequence of monetary policy, as is inflation. Japan's persistent deflation is due entirely to an inadequate monetary policy response from the BoJ, once the property and stock market bubbles of the late 1980s burst. As BoJ governor, Masaru Hayami is responsible for Japan's unrelenting deflation over the last three years, which may actually be worsening. How can this be when Hayami is pumping trillions of yen into the banking system, causing a number of economists to say, "The BoJ is doing all it can"? This money is propping up Japan's commercial banks, which are technically bust as everyone knows, but most of it goes straight back into Japanese Government Bonds, rather than the broader economy. Consequently there is very little money in circulation in Japan, evidenced by money supply data which has fallen back to only 3.3 percent (M2+CD), woefully low for an economy in the grip of a destructive deflation, defined as falling output, prices and profits. To make matters worse, whenever the MoF has ordered the BoJ to intervene and weaken the yen, Hayami has sterilised the excess funds, maintaining a shortage of yen in circulation. Japan's lethal central banker has always favoured a strong yen, regardless of this policy's consequences for a persistently weak economy, which Hayami blames on the government. While the BoJ Governor's policies have helped to maintain an overvalued yen, as Vice Minister of the MoF Haruhiko Kuroda indicated recently, a further decline is just a matter of time. No economy has ever escaped the grip of a destructive deflation without devaluing its currency. Hayami's term at the BoJ expires on 20th March and his replacement will almost certainly announce an inflation target. To achieve this, the BoJ will literally print money, in a radical reflation effort, to jumpstart the economy. This would also succeed in weakening the yen. Ideally, the government would use the newly created money to purchase Japanese property and shares. Confidence would improve as they rose and once deflation was replaced by a modest rate of inflation, cash-rich savers would be more inclined to spend. This remains the least painful way for Japan to end its deflationary recession. How low could the yen go in the process? Targets are always a guess and sentiment will also be influenced by what is happening in Euroland and the US. Nevertheless, my longstanding target is at least ¥200 for both the dollar and euro. Remember, the yen was pegged at ¥360 to the dollar by General Douglas MacArthur, during post WWll reconstruction, and stayed there as part of the Bretton Woods Agreement of 1945, until effectively scrapped by US President Richard Nixon in the early 1970s. Dollar/yen last traded at ¥200 in early 1986. To ask the rhetorical question: Do the subsequent economic paths of the US and Japan since 1986 justify today's dollar/yen rate?

With currencies today, it is a question of which looks least ugly. Of the big three, the euro carried that label after its virtual launch in January 1999, before passing it to the yen in December 2000. Then it was the US dollar's turn, briefly, commencing in mid-July this year. Judging from the charts, the yen is now wearing the ugly label, despite Hayami. If so, there will be less interest in euro/dollar, as we have seen over the last three months, during which the trading band centred on 98 has continued to narrow. Inevitably and eventually, something will give. We'll see it first on the chart, and that will author a new script for currency traders to espouse. While trying to anticipate a breakout is usually a mug's game, I'll have a go. Technically, I maintain the euro is consolidating against the dollar in its first step above the base. While this pattern should eventually support an additional upward break, there is at least a 50/50 chance that it will first take out recent lows near $0.96 and retest the base, as more traders abandon their long positions established earlier in the year. In this event, the euro would fall a little further, but probably not much below $0.94, before rallying back up into the current pattern. The script? Dismay over Euroland's economic performance and possibly US success against Saddam Hussein. A failed break below $0.96 would most likely be followed by a move above parity. If this held for several days, sentiment towards the euro would improve once again, helping it toward my eventual target in the $110 to $115 range. What might the script be? Concern over the US economy due to a drop in consumer spending, and debt

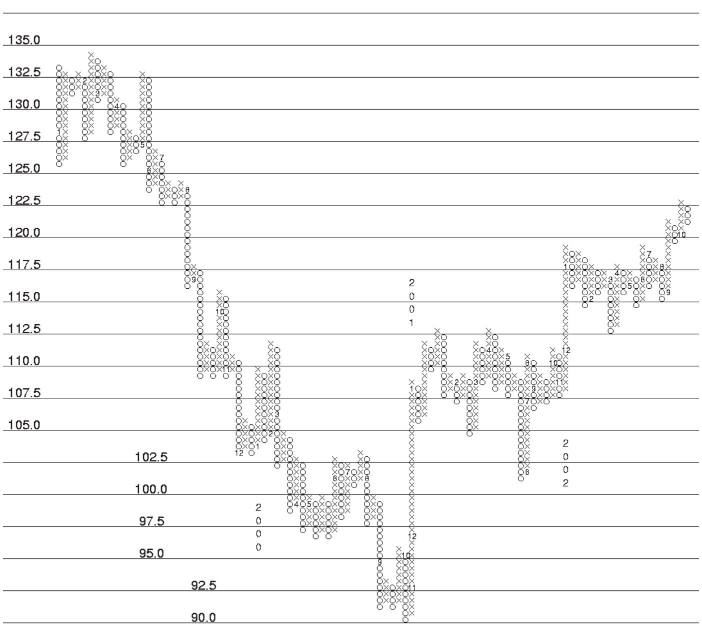
US Dollar per 1 Euro (0.004)



Japanese Yen per 1 US Dollar (0.5)



Japanese Yen per 1 Euro (0.5)



problems for US corporations following the leveraging of balance sheets in the 1990s. If the US economy is seen as a bigger risk than Europe, central banks could shift more of their reserves from dollars to euros.

Chart review of important and topical currencies - *These and hundreds of other 3-box reversal closing basis point & figure charts are available on our website, www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

Euro/dollar ($0.9847) - While I maintain that the current trading range is the first step above the base, prior to additional gains over the medium term, it still has a top-heavy appearance, despite recent firming. The euro needs to move above parity to offset the possibility of a temporary downward break.

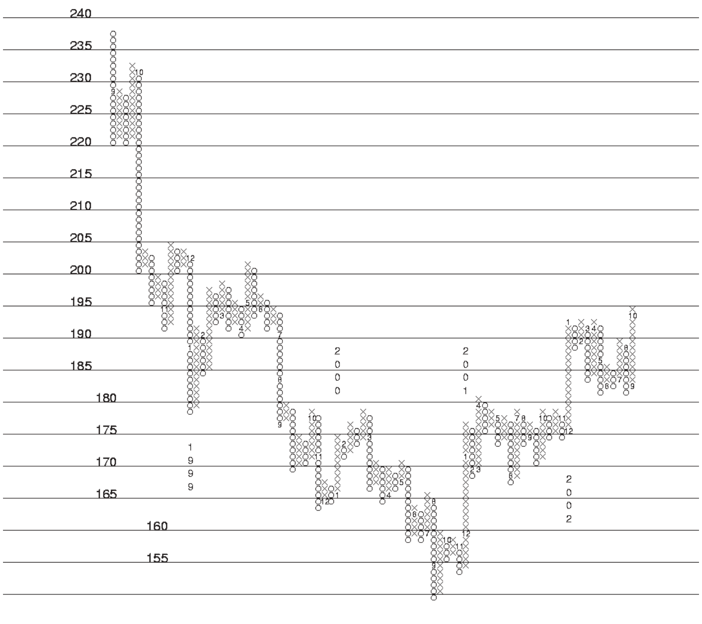
Euro/yen (¥120.83) - A consolidation is underway but a move below ¥119, which seems unlikely, is necessary to significantly delay scope for further gains towards the 1999 peak area. On a longer-term basis, this pattern can support significantly higher levels.

Dollar/yen (¥122.69) - Here also a consolidation of gains is underway. The dollar would probably have to move under ¥119.5, which appears unlikely, to indicate the need for more support building before the rally is extended towards this year's earlier peak area.

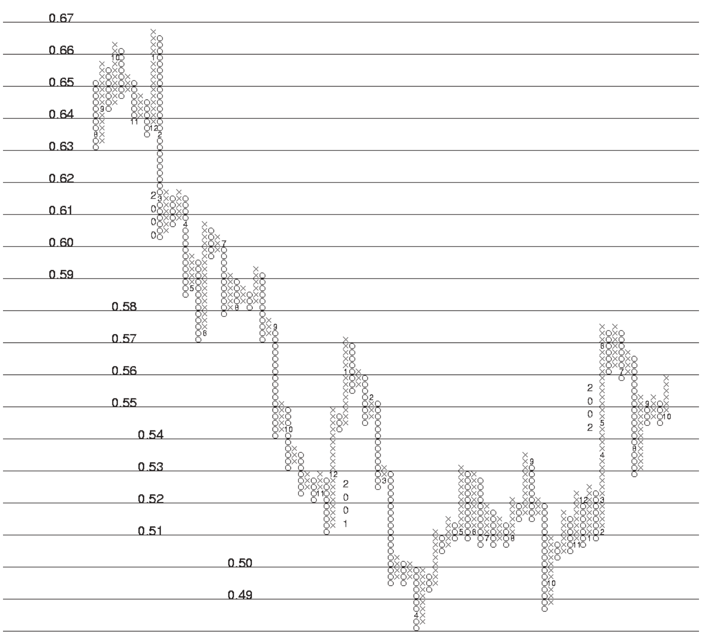
Sterling/yen (¥192.88) - Similarly, the pound is consolidating gains following the upward break in early October. A move below ¥190, which seems unlikely, is necessary to suggest an upside failure and need for additional support building before the overall uptrend is extended.

Australian dollar/US dollar (US$0.5584) - Chart readers will note two main features to this chart - lateral resistance just above $0.57 and the overall H&S basing characteristics. A decline to $0.5420 is currently needed to delay a further rally towards prior resistance.

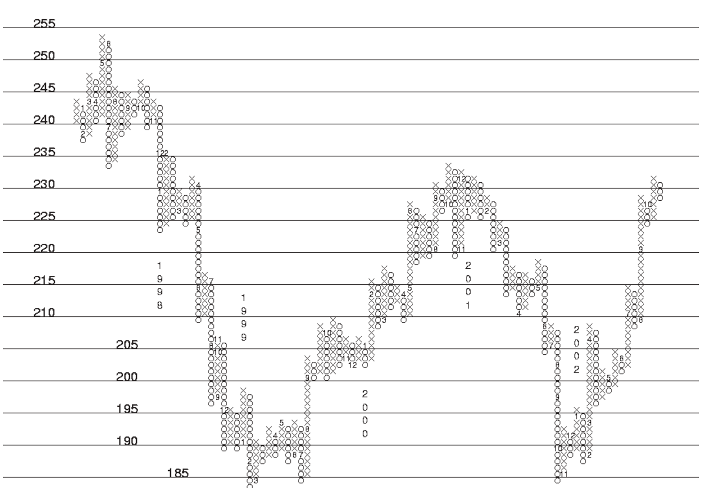
Strategy for currencies - The best opportunities, I believe, remain in yen shorts against various currencies. As these have appreciated against the Japanese currency I have raised trailing stops somewhat, in line with FM220's strategy. Happiness in trading is having core positions supported by a major trend, which has moved sufficiently in one's favour to make in-the-money stops a feasible and sensible tactical move. In other words, a portion of the open position profit is protected by stops, reducing risk to some profit erosion, while leaving the door open to further gains. It's the closest one can get to a free ride. The difficult part is knowing where to place stops. Too tight, risks being shaken out on a move of no great technical consequence. Too loose, risks substantial profit erosion if/when a larger than expected reaction occurs. No textbook, course or calculation can tell us where to place stops. It's a matter of observing each trend's particular characteristics, chart reading, intuition, money control and mostly luck. If the trend is often choppy, Japanese Yen per 1 Pound Sterling (1)



US Dollar per 1 Austrailian Dollar (0.002)



CRB Index NYFE (1USD)



as we have seen with the yen to date, I am inclined to use looser stops and manage a portion of the position with my Baby Steps, buy-low-sell-high tactic. However I seldom play both sides by going from long to short within the overall trend, because it is usually trying to be too clever. Instead, I try to ride a primary trend, increasing or reducing the position somewhat, in line with my short-term risk/reward perception, which I hope is more objective than mere wishful thinking. Needless to say, it is easier to ride a very consistent trend, and these are usually the stronger moves. The clearest warning that a significant contra-trend reaction will follow, is acceleration, which fortunately lends itself to tighter trailing stops. Most currencies are consolidating gains against the yen as I complete this issue. Consequently there is a risk that stops will be hit, adding to the overall volatility. Over the longer term, I maintain the yen has a long way to fall.

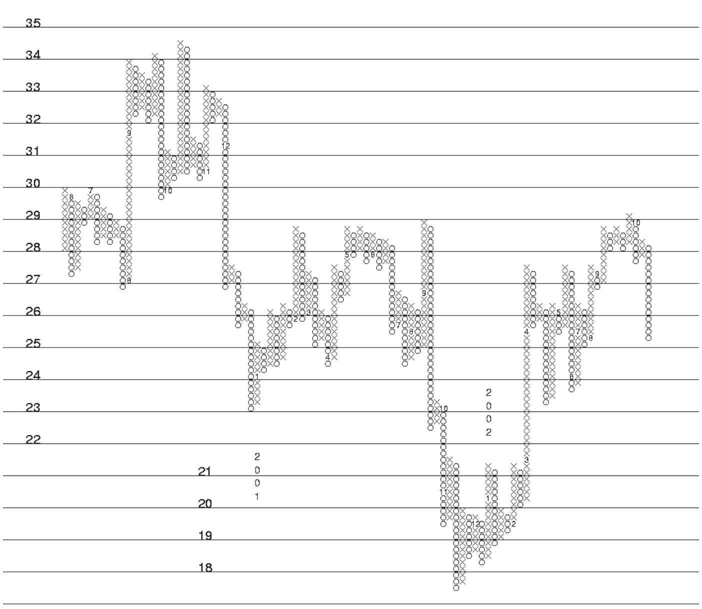
Commodities

- **CRB Index tests resistance from its 2000-2001 high.**
- **Crude oil has lost some of its war premium but natural gas has edged higher.**
- **Gold backed away from the upper region of its developing base but has now encountered support above the July low.**

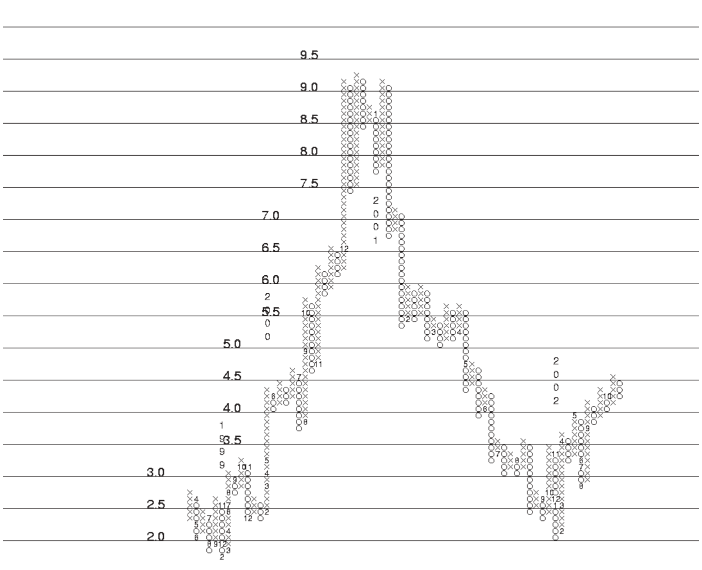
Foods and petroleum contracts have lifted the CRB. I last commented on this Index in FM218 (17/07/02), as it resumed its climb from the base. It recently tested its 2000-2001 highs, which should provide at least temporary resistance. However many who do not regularly follow commodities will be surprised by the extent of this year's gains, especially as inflation is supposed to be nonexistent and deflationary pressures increasing. This paradox is partly explained by petroleum contracts, which had been lifted by OPEC's supply cuts and prospects for a war against Saddam Hussein. However the rise in food contracts has been the biggest factor behind the CRB's gains. Prices for many foods had previously fallen so low that they were curtailing production, despite subsidies in many countries. However the biggest factor has been turbulent weather. With so many crops affected, is this due to a fluke coincidence or global warming? No one knows for sure but the trend has been for more erratic weather recently. In the short term, I suspect petroleum contracts will lead the CRB somewhat lower. Thereafter, food contracts are likely to take it above the 2000-2001 highs, helped by increasing speculative interest.

The probable return of UN arms inspectors to Iraq is somewhat bearish for oil, but the onset of war against Saddam Hussein would really push petroleum prices lower. When war appeared imminent, no trader dared be short, suppliers increased inventory and the US was still adding to its strategic reserves. However since the beginning of October the perception has increasingly been that war will be delayed by the return of arms inspectors and may not occur at all. This is unwinding

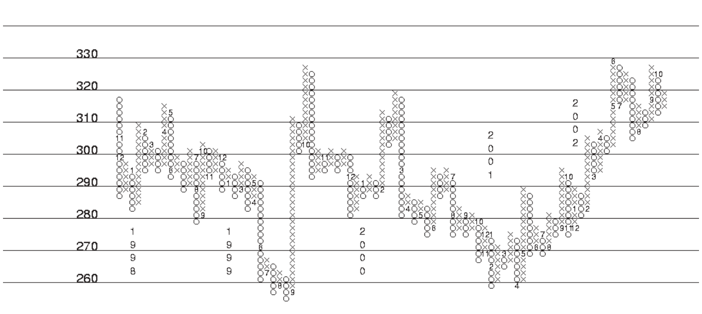
Crude Oil NYME 2nd Month Continuation (0.2USD)



Natural Gas 2nd Month Continuation (0.1USD)



Gold CMX 2nd Month Continuation(2USD)



some of the war premium, evident by crude oil's inability to sustain last August's break above the April to July highs evident between $27.80 and $28.40 (NYME 2nd month continuation). The price appears headed back to the mid-$20s region. It will certainly rise again if expectations swing back to the probability of war in the near future. However historic evidence suggests that oil would plunge once a military move against Saddam commenced. Long hedges would be replaced by short positions and OPEC discipline would crumble as producers scrambled to take advantage of high prices, while they could. A weak global economy and the prospect of increased production from Iraq would push crude oil back below $20.

Natural gas has extended its move above the base. Until this chart shows some loss of momentum by breaking the rising lows, I'd give the upside the benefit of doubt. Prices may be benefiting from a switch from oil to natural gas, which has certainly been a lot cheaper recently. However, if petroleum prices continue to weaken, this will eventually check gains in natural gas.

Gold's rally was checked by resistance near $330 once again but it has now firmed above prior support. This move has delayed completion of gold's multiyear base formation. Nevertheless it has encountered support above the July low recently. If it can now rally back towards this year's highs, this would once again demonstrate demand in the upper region of the base. It would also suggest that an upside breakout was drawing nearer. I maintain that gold is in the very early stages of a long-term cyclical recovery.

The Global Economy

- **The cost of crude oil remains a problem for the global economy but the price will decline once the Saddam Hussein weapons threat is resolved, one way or another.**

- **If there is going to be a war against Saddam's regime, it would be better economically, if not politically, that it occur sooner rather than after a long fandango between UN inspectors and obfuscating Iraqi officials.**

- **The US muddles through - just. Europe performs like an economic system designed by a committee. New Labour is digging a tax and deficit hole for Britain. Japanese officials are squabbling while shuffling a few deckchairs but not much else.**

Several articles have observed that oil prices are not the problem that they were in the 1970s. This is true for developed economies, which are more efficient users and also have the option of using natural gas for many requirements. However at the bottom line, crude oil near $30 a barrel (NYME) is a recipe for slow GDP growth at best. It is devastating for developing countries dependent on imported oil, especially as they must pay for it in US dollars. The greenback has continued to appreciate against most minor currencies. Crude oil will remain strong while most people expect a war in Iraq. Petroleum traders will be reluctant to short and suppliers will maintain large, unhedged inventories. Once war either commences or a non-military solution appears likely, the oil price will weaken in line with a change in market sentiment and supply/demand fundamentals.

Only fanatics welcome war, but sometimes it is the lesser evil. Some commentators, and especially those who oppose regime change in Iraq by military means, say that it would tip the global economy into recession, as we saw in 1991, after the last Gulf war. If war appears imminent, oil prices will rise but probably less than during the last Gulf war, because everyone has had ample opportunity to prepare for this eventuality and supplies from non-OPEC sources are more readily available today. However, since the US is no less interested than any other country in a credible UN-led solution to the problem of Saddam Hussein, and this is now a genuine possibility following President Bush's effective speech to the UN General Assembly, the prospect of a military conflict anytime soon has lessened. This is reflected by somewhat lower petroleum prices - a trend likely to continue as UN inspectors re-enter Iraq. It was always probable that US pressure would convince even Saddam that he has little choice, if he wishes to stay alive, other than to comply with all of the UN's demands. Nevertheless, based on previous experience of harassment and obfuscation by Iraqi officials, and the near certainty that Saddam has plenty to hide, a justifiably sceptical market will not reverse the entire war premium on oil prices while UN inspectors remain in Iraq. Moreover any complaints by UN inspectors would quickly revive the war premium. Consequently the inspections route, while preferable politically, not least to those soldiers and civilians whose lives would be at risk during a war, would probably exert a greater toll on the global economy, due to higher oil prices, than is justified by economic conditions. Conversely, a quick, short battle to remove Saddam Hussein from power would quickly reverse the oil market's war premium. Moreover, the prospect of substantial additional supplies from Iraq, once UN sanctions were lifted, would drive the oil price back below $20. Of course this is what OPEC fears most, second only to pressure on other Middle Eastern regimes to democratise. Meanwhile, assuming Saddam is not overthrown and does not leave of his own accord, his removal by military means, preferably with the UN Security Council's agreement, will remain a moral imperative.

The US remains more adaptable than other major economies and it is benefiting from both a monetary and fiscal stimulus. Cost savings via layoffs commenced earlier than elsewhere and continue. The US Federal Reserve moved more quickly and extensively than any other central bank in its effort to reduce the deflation risk. The war on terrorism has boosted government spending considerably. Consumers continue to spend, albeit less voraciously. So much for the good news. Excessive corporate debt, due to the late-1990's fashion for leverage, remains a considerable problem, which cannot be inflated away or easily paid down by earnings, secondary offerings of shares or asset sales. Deflationary pressures, including a comparatively strong dollar, remain a problem, particularly for US manufacturers. Too many consumers are financing consumption with increased borrowing, including the remortgaging of homes. Consequently the US economy should muddle through, avoiding a double dip recession at this time. However risks to the economy over the next few years will remain high, including a possible slump in consumer spending before capital expenditure increases, spreading deflation from Japan and temporary setbacks in the war against terrorism.

Europe is already in a double dip recession. Policy errors continue to plague Europe, including the (in)Stability Pact, the ECB's deflationists mandate, a one-shoe-(mis)fits-all monetary policy, too much central control from Brussels, an overemphasis on exports and underdevelopment of a consumer sector, Socialist labour policies, high taxes. These last two factors, in particular, have eroded confidence and deterred the 'animal spirits' necessary for a vibrant, market-oriented economic system. As central bank governor, Wim Duisenberg at the ECB is not a leader but someone who follows orders - in this case an inappropriate mandate, so it's 'full speed ahead and damn the torpedoes". Germany is at the heart of Euroland's economy and not having done very well during the 1990s growth years, it is even more vulnerable to stagnation and deflationary recession today. All of Europe has an underdeveloped consumer sector and wants to export. The problem is that it can't export that much to its overtaxed consumers and overregulated industries, or more competitive Asia. Consequently it is overly dependent on the US, which has problems of its own.

The UK economy is being slowly undermined by new Labour's gradual metamorphosis back into old Labour. In order to regain power, Tony Blair and Gordon Brown changed Labour from a leftwing, blue-collar Socialist collective, into a middle-of-the-road, market oriented party. The trouble is, many old Labour types only went along for the ride, wanting influence plus MP's salaries and benefits, while never shedding their Socialist convictions. As Chancellor, Gordon Brown got lucky, having inherited the outgoing Conservative's return to fiscal discipline, which he maintained. He also benefited enormously from a booming US economy. Blair and Brown controlled their left-wingers in order to ensure re-election. Subsequently, their ambitions and political leanings have combined with circumstances to undo the previous sound stewardship. Blair is bored by UK domestic policy, recognises that he has a sell-by date as prime minister and wants to be president of the European Union. Consequently he has acquiesced to most of Brussels' agenda, to the detriment of the UK economy, and promoted the euro on the fatuous argument that "it is our destiny". Meanwhile, Brown, despite being more of a yankophile than a europhile, has rediscovered his original Socialist leanings, being anxious to succeed Blair as PM. Consequently personal taxation has risen remorselessly, mostly via stealth taxes, and will jump again as the ceiling comes off National Insurance contributions next April. This will hit middleclass consumption, which has been the mainstay of the UK economy recently, very hard. For the first time since Margaret Thatcher's tax cuts, British citizens will pay a higher proportion of their income in taxes than Germans. Worse still, Brown's hubris led him to believe that he had banished the business cycle, despite gradually strangling the UK economy. Consequently, rising taxes will increasingly undermine Britain's free-market 'animal spirits', which Thatcher had re-introduced, during a massive increase in redestributive public spending, against the background of a global economic slowdown. There is no way for Brown to square this circle. He will borrow, buying time but at a cost to the future, which will eventually include higher interest rates. It only remains to be seen whether he will then cut government spending (unlikely) or raise taxes further, digging an even deeper hole for himself and unfortunately the UK economy.

In Japan, the BoJ's Hayami acknowledges there is a banking problem; PM Koizumi appoints a banking regulator who agrees in principle, if not as to what should be done about it - this is crisis recognition rather than resolution. Let's hope recognition of the problem, at least by some in Japan, leads to solutions. For too long Japan's bureaucrats have feuded, been in denial and proceeded with the forethought of somnambulants. The rest of East Asia retains its formidable dynamism but faces considerable problems in addition to the old issues of transparency and cronyism. These now include Islamic terrorism, which will devastate tourism - a critical industry for the less developed, lower cost regions. Industrialised East Asia, like Europe, is overly dependent on the US economy. With US consumers curtailing spending, there is still no other export market capable of taking up the slack. Lastly and most importantly, Japan's chronic deflation has spread to Hong Kong. China, which similar to the former British Colony also has its currency pegged to the US dollar, may be next. With its cheap labour and seemingly unlimited manufacturing capacity, China has certainly been a source of both regional and global deflation. It will devalue at some point, compounding regional problems. Other currencies will have to adjust downwards, replacing deflation with stagflation. At the bottom line, globalisation and the microprocessor have made the world super-efficient at manufacturing all manner of wonderful products, in excess of what we can consume. The gain is an abundant choice of quality products and declining prices. The risk is destructive deflation or stagflation if supply overwhelms demand for more than a comparatively brief period. Other growth-generating, non-manufacturing uses for the microprocessor will be discovered, but their timetable is unknown.

And Finally…

The Chart Seminar, 21st and 22nd November, in London - This will be one of my last 2-day seminars, as I move on to other challenges, such as my website commentary. However I have always enjoyed the seminars, despite the effort involved in conducting an unscripted, free-flowing workshop, tailored in line with delegates' market interests. This November's TCS will be no less challenging, given market action, but all the more interesting as a consequence. Our discussions will range from long-term trends to timing signals, applying the principles of behavioural technical analysis to markets on the day. To read more about TCS and enrol, visit my website - www.fullermoney.com, or call Helen Gent on +44 (0)20 7352 4001.

The Fullermoney Audio - Launched in September, this is a free service for Fullermoney subscribers. You will find the Audio recording on my website and no additional password is required once you login. As a subscriber, you probably have a login name for the site. If not, you can request one via the site email. The Audios are my unscripted and unrehearsed thoughts, in which I update views, and address any dramatic news developments and dynamic market moves, which concern us all.

Comment of the Day on www.fullermoney.com - I still meet or hear from subscribers who ask for my views but are not aware of my Comment of the Day on the Fullermoney website, which I have been writing since May. Some fear that it will be an additional cost. No, the only cost is your time. I write Comment of the Day for subscribers, current and prospective, and it is free. One quick visit will show you whether or not you wish to bookmark this site, as many people do. If you like Fullermoney, you will probably be interested in many of the comments and articles posted on my website, which is interactive. Thanks to your interest, I now have thousands of eyes with which to scan the web, and I so appreciate emails, plus the articles and research reports forwarded.

The earliest target day for FM223 is Tuesday 19th November.

"It ain't what a man don't know that makes him a fool, but what he does know that ain't so."

Josh Billings

Best regards - David Fuller

Fullermoney a division of Stockcube Research Limited Suite 1.21 Plaza 535 Kings Road London SW10 0SZ UK
Website: www.fullermoney.com ***Email:*** research@chartanalysts.com ***Tel:*** +44 (0) 20 7351 5751 ***Fax:*** +44 (0) 20 7352 3185 ***Single Issue Price*** £35